Collusion, Creative Bribery & Subcontracting

What to Look Out For In Your China Supply Chain

From high profile tainted food scandals to adulterated construction materials causing buildings to collapse, supply chain risks in China continue to generate international headlines.

As reported time and time again, supply chain risk is realised when an uncertain or unpredictable event, affecting one or more of the parties within a supply chain, negatively impacts the achievement of business objectives. To manage and protect against these hazards, it is important that companies consider a structured and synergetic supply chain risk management process that seeks to optimise the totality of the supply chain strategy, taking into account the use of processes, human resources, technology and knowledge. The aim of supply chain management should be to control, monitor and evaluate supply chain risk, which will serve to safeguard continuity, maximise profitability and enhance enterprise value.

Recent cases involving a wide range of different industries have resulted in substantial damage to the reputations and finances of the companies involved. Following fast food giant McDonald's tainted meat scandal in Shanghai, which was reported by local Chinese channel Dragon TV in July 2014, the company saw sales across the Asia Pacific, Middle East and Africa regions drop by 14.5% in the month of August 2014. While the Chinese and Japanese markets led with the fastest sales drop, an overall monthly sales drop of 3.7% was recorded across the globe, the worst fall recorded in ten years.[1]

The same TV report, which showed workers picking up food from a factory floor as well as mixing meat beyond its expiration date with fresh meat, additionally implicated Yum Brands, the biggest operator of fast-food restaurants in China (and home to such chains as Kentucky Fried Chicken, Pizza Hut and Taco Bell). As a result, Yum Brands saw an almost immediate 4.2% dip in shares. Fast forward to the present day and even months later, both companies are still dealing with the aftermath and having to work hard to regain consumer trust.

In another notable recent example, Aston Martin were forced to recall more than 5,000 cars earlier this year after it was discovered that one of their PRC supplier (engaged via a Hong Kong trading agent) was using counterfeit material to mould and produce plastic pedal parts. The PRC supplier was labelling their material as being sourced from DuPont (in accordance with Aston Martin's requirements) - but it was anything but. As a result the famous British car manufacturer was quoted as "*...planning to re-source the manufacture of pedal arms from China to the United Kingdom as soon as possible in 2014.*"[2]

These cases, and many others, continue to demonstrate the need for ongoing and thorough reviews of current and prospective business partners and suppliers. In many instances, FTI Consulting has seen that problematic issues in the supply chain are often a result of corruption, bribery or a lack of understanding as to who is actually moving the products from A to B within the business operations. A greater understanding of the potential red-flags to be aware of in these instances can help companies mitigate such risks; and in doing so enable the companies to better protect themselves.

Risky Business

Supply chains in China are often multi-tiered and tangled. Control mechanisms and transparency tend to be limited beyond first-tier suppliers, making it challenging for companies to really understand their supply chain. Another problem is the lack of legislative control over the logistics industry. For example a contracted logistics supplier may well outsource significant aspects of the trucking and storage of products without any managerial oversight. FTI Consulting has witnessed this with contracted trucking agents being involved in the syndicated theft of our clients' high-end consumer products, or the substitution of goods with high quality counterfeits whilst en-route to a shipping port.

The most blatant examples FTI Consulting has encountered of supply chain risk have included:

- Bribery of staff;
- Suppliers subcontracting the manufacture of orders to unauthorised third parties;

1 http://time.com/3311608/mcdonalds-sales/

2 http://www.businessweek.com/articles/2014-02-05/james-bond-s-sports-car-has-chinese-supply-chain-problems

- Suppliers colluding with each other to manipulate the bidding process;
- Subcontracting transport and logistics needs to low level unregulated providers; and
- Undisclosed conflicts of interest with purchasing and/or management staff.

This article will examine two of these issues in more detail:

Bribery of Staff

Bribery of staff (most often procurement and quality control/social compliance staff) is arguably now better concealed and less open than in days past. For cash hand-outs the issuing of false and/or inflated invoices to trading agent intermediaries is a common ploy, with the excess amounts flowing back to the procurement staff.

Even if cash is not involved, there are myriad improper incentives in common usage today. Leveraging local connections to help a child get into a good school, the long-term loan of a car or other items of value, the arranging of a family holiday, the employment of a cousin etc. — these are all benefits that are easy to arrange and hard to spot from afar.

Low-level incentivising activities are virtually constant in the Chinese market, with classic examples being the provision of cultural gifts (e.g. mooncakes) at opportune times, hosting purchasing staff at lavish dinners and Karaoke television (often referred to as KTV) sessions, and even something as simple as deliberately losing money at friendly games of mah-jong every time the quality control team makes an inspection. This culture of gift-giving and entertainment is woven into the fabric of doing business in China, blurring the distinctions between personal and professional relationships.

Unauthorised Subcontracting

How a company assesses and manages its supply chain risk is no longer considered "a company's private business." Policymakers, insurers and credit rating agencies are increasingly scrutinising a companies' risk management practices, including supply chain risks. At FTI Consulting we have found that many clients report increased requests from customers who want to understand their business continuity plans in China and how they will keep their customers fully supplied no matter what happens.

China is arguably the largest manufacturer of products in the world, and with this phenomenon comes the need to move parts, semi-finished and finished goods around the country at a tremendous pace. The PRC Government recognised this need several years ago and embarked upon a huge transport infrastructure campaign that has witnessed the rapid construction of roadways high speed rail networks, construction of airports, and the deregulation of the airline business — all in an attempt to support the need to move goods from A to B as quickly as possible.

However, this phenomenal growth has led to a fractured and deregulated transport and logistics industry where small time players have moved in to get 'a piece of the action.' Pressures for 'on-time' delivery on contracted logistic suppliers often leads to unauthorised subcontracting of transportation and storage requirements to the smaller unregulated companies that now proliferate the lower level logistics world, particularly in the third, fourth and fifth tier cities.

Unauthorised subcontracting within the Chinese logistic industry is very common

By way of example, FTI Consulting was engaged by a global consumer electronics manufacturer that specialised in producing some of the most sought after high-end home entertainment systems in the world. Our client had a specific issue relating to the systematic theft of its products during transit from its factory in Southern China to the port of Shenzhen.

The FTI Consulting investigation found our client's contracted logistics company was subcontracting the trucking of the products to a small unregistered trucking company that was frequently stopping delivery vehicles mid-journey to allow local village thieves to remove quantities of finished product, and replacing the stolen items with boxes packed with bricks.

Peeling Back the Layers

Employing a proactive approach and ongoing system that allows for further scrutiny and improvement to your company's supply chain is vital to protecting the value and reputation of your business, this is process is commonly known as "Know Your Supplier" (KYS) due diligence. However, for some, conducting a thorough yet prudent integrity check on its supply chain can be a complex and daunting task.

Useful KYS due diligence also sometimes falls in between the responsibilities and duties of the Product Quality and Social Compliance departments. In other words, in between ensuring that products are well made and under good working conditions, the aim of KYS due diligence is to uncover and understand *who* exactly the suppliers are, i.e. What individual or individuals own the business, what else do the owners do, what other businesses do they own, what (undisclosed) business interests and personal relationships do they have with each other and the company's own staff.

In China, personal and professional relationships are almost always deeply intertwined and it is a continual challenge to untangle this web to make it clear who is connected to whom, a point that should be taken into careful consideration when trying to understand how your suppliers work and who is making the final decision on their practices.

An effective KYS process begins with an important information-gathering phase. Pinpointing what information the company currently has on its suppliers and logistics providers, and when this information was last updated. Once you have compiled records on each of the players, risk managers can use this to data establish priorities on whom or what areas are potentially more risky and require further investigation. At this stage, any glaring information gaps should become more obvious and furthermore, risk profiles can help point out who requires further screening.

A common misconception of conducting KYS due diligence in China is that information is hard to locate. In reality, it is the opposite. Chinese companies (that do not have any state interest) are required to file in detail registration and operational information with relevant authorities, and as such it actually a fairly straightforward process to secure documentation on potential or current business partners. However, conducting comprehensive KYS due diligence is not a one-off 'tick the box' exercise that takes place in the beginning of a relationship: rather it is an ongoing process that requires consistent internal engagement and accountability.

Determining what to do with the results of your research and investigation is also an important part of the KYS procedure. Based on industry standards and practices, companies may decide it more beneficial to employ a zero tolerance policy or 'a three strikes and you are out' method to determine whether they continue to have an active relationship with certain business partners. Ensuring that your findings are stored in an easy-to-access and readable data storage and retrieval system and that business partner profiles are updated on a regular basis, is critical to understanding where the "knowledge gaps" are and implementing a strong supply chain risk assessment strategy.

Covering Your Bases

Addressing potential risks in your supply chain is a serious priority that shouldn't be put on the backburner until the next media expose puts a brewing crisis in the limelight and forces an internal investigation and restructure of policies.

The China Checklist: Tips on KYS Due Diligence

- One of the best ways to kick-start such a process would be to assess how much is currently being done in terms of quality control and social compliance audits. Then using this information to determine your priorities going forward and understanding how additional due diligence research could be effectively incorporated into these incumbent checks (if possible) and how it would supplement ongoing efforts.
- To efficiently conduct KYS due diligence, companies should require that their suppliers submit regular documentation on their operations. Once the suppliers themselves provide the necessary information for review, the process becomes more about verification rather than investigation. Should discrepancies arise during the fact-checking period, however, this could highlight the need for an investigation.
- Investigative KYS verification or research should take the form of checking official records that are publicly available (such as via the Administration of Industry & Commerce in China). Along with this, companies can check applicable local regulatory, litigation and bankruptcy records, including inspection of local sanction and compliance databases, and reports from community, environmental and worker safety/rights' organisations. All these sources can provide significant and valuable insights on third-party suppliers or business partners.
- Research, especially online research, should be conducted in English and Chinese to locate any relevant information connected to the supplier. Trading websites, industry forums, job postings and (increasingly of importance) social media searches can build a good repository of information and provide useful details on a suppliers' profile in the marketplace.
- A discreet site visit, to ensure the supplier does indeed exist and is currently operational at its specified address(es) should also be considered, especially if research doesn't bring up specific information and is, rather, bringing up more unanswered questions.
- A discreet audit to ensure contracted logistic suppliers are not subcontracting to unauthorised agents is also recommended.
- For more in-depth research to supplement your KYS process, you could consider: An analysis of the historical background of the supplier and its owners over time; discreet inquiries regarding a supplier's current capacity and labour supply arrangements; investigative research and discreet inquiries regarding the likelihood that subcontractors are being used; and inquiries concerning potential breaches of contracts, local regulations, theft, fraud, money laundering, corruption or other business risks.

At FTI Consulting, we have developed for our clients effective KYS programmes that have substantially reduced risk and provided their business operations with significant benefits, including:

- The ability to anticipate and respond promptly to external trends and developments that may impact their supply chain elements.
- To have greater influence and control over their supply chain partners.
- To have a greater understanding of the interests and problems of all supply chain partners.
- Adopt a better balance between opportunities and threats that exist within their supply chain.
- To enjoy a competitive edge through the acceptance and management of controllable risks.

About the Author

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In addition to developing a portfolio of clients across the region, he is experienced in leading and conducting a wide variety of business intelligence, due diligence and corporate investigations throughout Asia Pacific. Mr. Hallahan has also prepared numerous corporate governance and compliance strategies to assist clients in responding to the UK Bribery Act, the Foreign Corrupt Practices Act (FCPA) and Chinese government regulations.

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